Press Briefing Memo
For
August 3, 2001 Tax Shelter Staff Discussion Draft

Introduction

In the last Congress, Chairman William V. Roth, Jr. (R-DE) and Ranking Member Daniel Patrick Moynihan (D-NY) directed the staff of the Senate Finance Committee to design a legislative response to the growing problem of abusive tax shelters. The Finance Committee staff released a preliminary draft proposal on May 24, 2000, and a revised proposal on October 5, 2000. At the beginning of the 107th Congress, then-Chairman Charles E. Grassley (R-Iowa) and Ranking Member Max Baucus (D-Mont.) directed the staff to continue working on a legislative response to the problem of abusive tax shelters. Pursuant to their instructions, the staff has prepared a new draft proposal, which is described below.

Senator Baucus and Senator Grassley are concerned that taxpayers continue to use abusive tax shelter transactions to avoid paying taxes that they properly owe. They are equally concerned, however, that any legislative proposal not be overly broad so as to impede legitimate business transactions. In addition, they recognize that the Treasury Department has been working to develop and refine regulations designed to detect abusive transactions and do not want to interfere with those efforts. In light of these concerns, the new draft proposal has been refocused to emphasize disclosure of potentially abusive transactions by both corporations and individuals and to prescribe meaningful penalties for all participants in tax shelter transactions who fail to comply with the Treasury regulations.

The new draft proposal is intended to enhance the tax shelter regulations implemented by the Treasury Department in February 2000. If, however, future experience with those regulations indicates they are not effective in combating tax shelters, Senator Baucus and Senator Grassley will consider further action to target abusive transactions.

Overview of the New Draft Proposal

The new draft proposal reflects the Finance Committee staff's careful consideration of extensive comments submitted by taxpayers and other interested parties. The new draft proposal shifts from an enforcement strategy based primarily on penalizing taxpayers, to one that encourages greater disclosure of potentially abusive transactions. Specifically, the new draft proposal moves away from the strict liability penalty of the October 2000 draft and instead encourages disclosure by providing a safe harbor from penalties if taxpayers disclose potentially abusive transactions and otherwise satisfy the requirements described below. The new draft proposal is designed to enhance the disclosure regime implemented by the Treasury Department in regulations issued in February 2000, and allow Treasury and Congress additional time to evaluate the effectiveness of those regulations.

In order to encourage disclosure of abusive transactions, the new draft proposal increases the penalty for understatements attributable to tax shelters from 20% to 40%, but provides a safe harbor from the 40% penalty if:

a. There was substantial authority for the tax treatment of the shelter;
b. The taxpayer adequately discloses the relevant facts affecting the tax treatment of the shelter in its tax return; and
c. The taxpayer reasonably believes it will more likely than not prevail on the merits of its tax treatment if challenged by the IRS (a greater than 50% likelihood).

Under the new proposal, taxpayers may establish "reasonable belief" and avoid the 40% penalty if they rely on the opinion of a tax advisor who is independent of the contested tax shelter transaction. A taxpayer may not avoid the penalty through reliance on an opinion that is rendered by a tax advisor who has a financial interest in the transaction or otherwise has a conflict of interest or lack of independence. In addition, a tax opinion based on unreasonable facts, assumptions, or representations will be similarly disqualified, even if it is rendered by an otherwise independent tax advisor.

The new draft proposal removes the requirement that a tax shelter understatement be substantial before a penalty is imposed. To minimize the administrative burden of complying with the new disclosure regime, the new draft proposal includes a de minimis rule providing that transactions giving rise to understatements of tax of less than $50,000 will not be subject to the increased penalty. All taxpayers will be subject to the same tax shelter rules.

The new draft proposal also requires the Treasury Department to list transactions that have substantial authority as well as those transactions that lack substantial authority. This mechanism is designed to provide the Treasury Department with the means by which it can alleviate the need for taxpayer disclosures of particular transactions whose status as a tax shelter may be uncertain.

The new draft proposal also is intended to coordinate with the Treasury regulations regarding the tax shelter disclosure, registration, and investor list requirements. Accordingly, the new draft proposal enhances the effectiveness of those regulations by invoking penalties against tax shelter participants who refuse to file a tax shelter disclosure statement with their returns, as required by the regulations (and for which a penalty does not exist under current law). Senator Baucus and Senator Grassley believe that it is very important that the IRS and the Treasury Department be able to obtain adequate information from taxpayers for purposes of enforcing the tax laws. The separate penalty is intended to reinforce this ability. However, they expect that the disclosure requirement under the penalty regime would be coordinated with the separate disclosure requirement under the Treasury regulations to reduce compliance burdens on taxpayers.

To enhance the ability of the IRS and the Treasury Department to obtain information about abusive transactions, the new draft proposal also expands the types of transactions promoters must register as confidential tax shelters to include transactions sold to individuals as well as corporations. The new draft proposal further reinforces the Treasury regulations by increasing the penalty imposed on tax shelter promoters and organizers who refuse to maintain lists of their tax shelter investors, as required by the regulations. The new draft proposal also expands the current penalties for aiding and abetting the promotion of tax shelters. It also increases the penalty on promoters who furnish false or fraudulent statements in connection with tax shelter transactions.

Because of the important role of tax advisors in our voluntary system of compliance, the new draft proposal adds a provision authorizing the Treasury Department to censure tax advisors or impose monetary sanctions against tax advisors and firms that participate in tax shelter activities and practice before the IRS. In addition, the Treasury Department would be required to publish the names of individuals and firms who are involved in inappropriate tax shelter activities, and notify the IRS Director of Practice and state licensing authorities of any such violations.

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The Finance Committee welcomes public comment on the new draft proposal. Please direct your comments to John Angell, Majority Staff Director, and Kolan L. Davis, Republican Staff Director, of the Senate Finance Committee, 219 Dirksen Senate Building, Washington, D.C. 20510.